

**LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS**

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FISCAL IMPACT STATEMENT

LS 8139

BILL NUMBER: HB 1899

DATE PREPARED: Jan 25, 1999

BILL AMENDED:

SUBJECT: Insurance Premiums Tax rate reduction.

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FUNDS AFFECTED: X GENERAL
DEDICATED
FEDERAL

IMPACT: State

Summary of Legislation: This bill reduces the Insurance Premium Tax from 2% to 1.3% over a five year phase-in period.

Effective Date: January 1, 2000.

Explanation of State Expenditures: The Department of Revenue and the Department of Insurance will have some administrative expenses associated with making the changes on tax forms, instructions and computer programming.

Explanation of State Revenues: The Insurance Premium Tax is assessed on gross premiums received on policies covering risks in the state of Indiana. The tax base is comprised of premiums written or renewed in the past year minus deductions of reinsurance premiums, dividends paid to resident insureds, and premiums returned. The tax rate is currently 2.0% of these net premiums. The tax is paid by all insurance companies doing business in Indiana, however, companies domiciled in Indiana may elect to pay the Corporate Gross Income Tax in lieu of the Premium Tax. Revenue from the Premium Tax is deposited in the state General Fund.

Reducing the Premium Tax rate could affect revenues from the Insurance Premium Tax, the Gross Income Tax, and the Supplemental Net Income Tax as follows:

Insurance Premium Tax: A reduction in the Insurance Premium Tax rate may affect domestic insurance companies differently than out-of-state entities:

(1) *Effect on domestic companies:* Decreasing the Insurance Premium Tax rate by 35% would not simply reduce the amount of tax due on premiums written in Indiana by the same rate. This is partly because domestic companies may elect to pay the Gross Income Tax in lieu of the Premium Tax. In fact, of the more

than 130 insurance companies domiciled in Indiana, only 39 currently elect to pay the Insurance Premium Tax. Only \$4,556,824 in Premium Tax was paid by Indiana domiciled insurance companies in 1997. If the Premium Tax rate is lowered, more companies may find it advantageous to pay the Premium Tax, simultaneously reducing Gross Income Tax revenue.

(2) *Effect on insurance companies not domiciled in Indiana:* The impact on out-of-state insurance companies varies with each state of domicile. This is due to Indiana's retaliatory tax provision, which provides that premiums written in Indiana by a company not domiciled in Indiana are taxed at either Indiana's rate or the rate in that company's home state, whichever is higher. The varying effects of the retaliatory provision are outlined in the following paragraphs:

(a) *Rates of 2.0% and above:* Premium Tax revenue collected from companies domiciled in states with a rate of 2.0% or higher would not change, no matter how low Indiana's rate was set. Because of the retaliatory provision, Indiana would collect at the higher of the two rates, which would still be at least 2.0%.

(b) *Rates between 2.0% and 1.3%:* Under this bill, Indiana will lose some revenue from companies in states where the Premium Tax rate is below 2.0% but above 1.3%. Connecticut, for example, has a rate of 1.75%. Under current law, the tax on premiums written by Connecticut companies in Indiana would be assessed at 2.0%. After a change in Indiana's rate to 1.3%, taxes on Connecticut premiums would be collected at 1.75%, the higher of the two rates. The retaliatory provision mitigates the potential loss with companies from states with premium tax rates between 2.0% and 1.3%.

(c) *Rates below 1.3%:* For companies domiciled in states with rates below 1.3%, the effect would be to reduce taxes paid in Indiana by 35%. The highest rate that would be applied would now be 1.3%, not 2.0%.

Although the retaliatory provision mitigates the potential loss, Premium Tax revenue from out-of-state companies would likely decrease whenever the rate is lowered. The net effect depends heavily on how many domestic companies switch to paying the Premium Tax rather than the Gross Income Tax. The impact of the proposed rate change on Insurance Premium Tax revenue was estimated using a model that included the retaliatory tax effects. Several important assumptions were made:

- Although this bill proposes a five year phase-in by reducing the rate to 1.3% by 2004, the full impact of a 0.7% reduction was assumed to happen all at once to demonstrate the maximum effect of this proposal.
- Based on recently proposed or enacted legislation, changes in the premium tax rates in neighboring states were incorporated in the model. The new rates that were applied were: 1.4% in Ohio; 1.5% in Kentucky; 1.5% in Illinois; and 1.3% in Michigan. All other states were assumed to maintain the same rates imposed in 1997.
- The majority of Indiana domestic insurance companies do not pay the insurance premium tax. If the rate was lowered, some companies may elect to pay the premium tax. It was estimated that a 1.3% rate would be sufficient for most companies to make this transition. For the estimates presented here, it was assumed all domestic companies would pay the premium tax.

Given the assumptions stated above, lowering the Insurance Premium Tax rate from 2.0% to 1.3% would cause an annual reduction of \$2,102,940 in Premium Tax revenue. The Department of Insurance (DOI) has estimated that such a change would generate a reduction of \$32,882,834. The discrepancy between these projections can be explained by the inclusion of the “switching” effect in the model used to prepare this analysis. The DOI’s estimate does not include the effect of all domestic Indiana companies electing to pay the premium tax due to the lower rate, which generates almost enough new revenue to offset the loss from out-of-state companies.

Gross Income Tax: The Gross Income Tax is normally assessed on the total gross receipts of a corporation’s transactions in Indiana. However, not all of the gross receipts of an insurance company are taxed under the Gross Income Tax. The tax rate is 1.2%, and revenue from this tax is deposited into the state General Fund.

Only 39 of the insurance companies domiciled in Indiana currently elect to pay the insurance premium tax. The remaining companies pay a total of approximately \$30 M in Gross Income Taxes. If the premium tax is reduced, more companies will find it advantageous to pay the Premium Tax. In the model used for this analysis, all companies were projected to switch to the premiums tax, reducing Gross Income Tax revenue by the full \$30 M.

Additional analysis is currently being performed to determine exactly how many companies would switch from paying the Gross Income Tax if the premium tax rate is reduced to 1.3%. If some companies do not switch, Gross Income Tax revenue would fall by less than \$30 M and the projected loss in premium tax revenue would be even greater as fewer companies would pay this tax. The information presented in this analysis will be updated as more precise estimates become available.

Supplemental Net Income Tax: Supplemental Net Income Tax (SNIT) liability is specially calculated for domestic insurance companies. The tax base is the federal taxable income of the company adjusted by:

- (Step 1) Multiplying the federal taxable income by the ratio of premiums tax receipts from policies insuring persons or property in Indiana to total premiums receipts; and
- (Step 2) subtracting the company’s Gross Income Tax liability or the gross premiums tax liability, depending on which one the company has elected to pay.

The adjusted tax base as calculated above would then be multiplied by the SNIT rate of 4.5% to determine tax liability. SNIT revenue is deposited in the state General Fund.

If an insurance company switched from paying the Premium Tax or Gross Income Tax to the other because the taxes due would be less, the amount that would be subtracted in Step 2 would be smaller, resulting in greater SNIT liability. The DOR estimates that in CY 1996, \$18.4 M in SNIT was paid by domestic life and property and casualty insurance companies.

Given the reduction in the Premium Tax to 1.3% and the previously stated assumptions, SNIT collections would be affected by the net gain of insurance companies. According to the model, the companies choosing to switch taxes would pay \$27,819,448 in additional premium tax, but \$30,000,000 less in Gross Income Tax. These companies would not be able to deduct the net gain, or \$2,180,552 from their adjusted tax base (see Step 2 above), resulting in an annual state increase of \$98,125 in SNIT revenue (\$2,180,552 x 4.5%).

Net impact: The table below summarizes the net annual impact upon full implementation in FY 2005 of

reducing the premium tax rate from 2.0% to 1.3%:

Affected Tax	Change
Insurance Premium Tax	(\$2,102,940)
Corporate Gross Income Tax	(\$30,000,000)
Supplemental Net Income Tax	\$98,125
NET IMPACT	(\$32,004,815)

The projected impact of this bill is a \$32,004,815 decrease in state General Fund revenues. It must be noted that reducing the Premium Tax will reduce the cost of doing business in other states for Indiana's domestic insurance companies. If these companies remain in Indiana and prosper or if new business is attracted, corporate and personal income tax revenues could increase.

Explanation of Local Expenditures:

Explanation of Local Revenues: If a lower Premium Tax rate helps Indiana's domestic insurance companies expand, corporate and personal income tax collections could be increased, benefitting counties with local option income taxes.

If an insurance company relocated outside the state because of lower Premium Tax rates in other states relative to Indiana's 2.0% rate, local property tax burdens could be shifted to other taxpayers.

State Agencies Affected: Department of Revenue, Department of Insurance.

Local Agencies Affected:

Information Sources: Department of Revenue, Department of Insurance.